Strasburger Tax Strategies

Strasburger ATTORNEYS AT LAW

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IF YOU HAVE QUESTIONS REGARDING THIS MATTER, PLEASE CONTACT:

LUKE D. BAILEY
Partner, Dallas
901 Main Street, Suite 4400
Dallas, Texas 75202
214.651.4572
214.659.4167 Direct Fax
luke.bailey@strasburger.com

Taxes & Estates Group
Luke D. Bailey
James R. Browne
Daniel L. Butcher
Jack R. Dugan
R. Bradley Fletcher*
Drake A. Frazier
Farley Katz
Jack M. Kinnebrew
Michael A. McClelland
Charles J. Muller
John K. Round
Dani D. Smith

* not licensed to practice law in the state of Texas

Public Company 401(k) Plans Holding Company Stock In an Arrangement That Satisfied PPA 2006 Diversification Rules Before 1/1/2007 Have Hope of Last-Minute Reprieve From Notice Requirement, But Must Exercise Caution

Summary: PPA 2006 added new diversification requirements for public company defined contribution plans holding company stock. For example, a public company 401(k) plan that provides for matching or nonmatching contributions in the form of company stock is subject to the new diversification requirements, which generally apply for plan years beginning in 2007 (that is, in approximately two weeks for calendar year plans).

The diversification requirements include a requirement that participants and beneficiaries be notified of their diversification rights. Neither PPA 2006 nor recent IRS guidance are clear on whether the notice requirement applies to plans that already met the new diversification requirements before the enactment of PPA 2006 (for example, where company stock has simply been one of several investment alternatives in an arrangement meeting the self-directed account requirements of ERISA Section 404(c)). Although last-minute relief may be provided from the imminent January 1, 2007 notice requirement for plans that already met the underlying diversification requirements of PPA 2006 before PPA 2006's enactment, employers sponsoring such plans should exercise caution in view of the potential for exposure to harsh monetary penalties for failing to meet the new notice requirement.

Discussion: The Pension Protection Act of 2006 (P.L. 109-280; hereinafter, "PPA 2006") added new diversification requirements for any public company defined contribution plan, such as a 401(k) plan, that (a) permits or requires investment by participants in company stock and (b) is not a separate Employee Stock Ownership Plan ("ESOP"). These diversification requirements are contained in new IRC § 401(a)(35) and ERISA § 204(j). To be a separate ESOP that is exempt from the diversification requirements, an ESOP must (y) be a separate plan entity (that is, not a deemed separate plan that is in fact part of a larger plan entity) and (z) not hold any amounts attributable to past or present elective deferral or matching contributions. The new rules are effective for plan years beginning after December 31, 2006 (that is, they are effective January 1, 2007 for a calendar year plan).

IRC § 401(a)(35) and ERISA § 204(j) provide that:

- A plan may never require elective deferral contributions to be invested in company stock
- Subject to a three-year phase-in, a plan may not require employer contributions (i.e., matching or discretionary nonmatching contributions) to be invested in company stock in the case of any participant with at least three years of service or in the case of a beneficiary of a deceased participant
- The plan must offer at least three investment options, other than company stock, that are diversified and that have materially different risk and return characteristics

- Participants and beneficiaries must be permitted to sell company stock allocated to their account and reinvest in another investment option on generally the same basis as they are permitted to change other investment options, and the plan must permit investment changes to be made at least quarterly

IRC § 401(a)(35) is a tax qualification requirement. Plans that do not comply with IRC § 401(a)(35) risk disqualification by the Internal Revenue Service (the "IRS").

New ERISA § 101(m) requires employers to provide participants and beneficiaries in affected plans with notice of their IRC § 401(a)(35) and ERISA § 204(j) diversification rights. The notice must:

- Set forth the participant's or beneficiary's diversification rights (e.g., the right to sell freely the employer securities allocated to the participant's or beneficiary's account)
- Counsel the participant or beneficiary about the importance of investment diversification
- Be provided no later than 30 days before the first date on which the participant or beneficiary first has diversification rights

The ERISA § 101(m) notice requirement is not a tax qualification requirement. However, violations of ERISA § 101(m)'s notice requirement are punishable by the Department of Labor by the imposition of a $100 per-participant per-day penalty (e.g., conceivably $100,000 per day for a 1,000-participant plan).

Given the January 1, 2007 effective date of the new rules, the ERISA § 101(m) requirement to provide participants and beneficiaries with notice 30 days before the participant or beneficiary first has diversification rights leads to the conclusion that in the case of a calendar year plan, notice should have been provided no later than December 2, 2006. However, on November 30, 2006, the Internal Revenue Service (the "IRS") published Notice 2006-107, which provides limited transitional relief with respect to the timing of the notice required by ERISA § 101(m) and contains a model notice. Notice 2006-107 states that the Department of Labor, which has jurisdiction over the ERISA § 101(m) notice requirement, has advised the IRS that in no case will notice be required to be provided earlier than January 1, 2007. This means, for example, that a calendar year plan generally has until January 1, 2007 to provide the notice. Here is a link to Notice 2006-107: http://www.irs.gov/pub/irs-drop/n-06-107.pdf (link live in PDF)

Notice 2006-107 does not specifically address the issue of whether a plan that already complied with the diversification requirements of IRC § 401(a)(35) and ERISA § 204(j) before PPA 2006's enactment (for example, a public company 401(k) plan that simply permitted company stock as an investment among several materially different and diversified investment alternatives available under the plan in an arrangement meeting the requirements of Section 404(c) of ERISA) are subject to the ERISA § 101(m) notice requirement. The better argument seems to be that they are. Such a plan is an "applicable defined contribution plan" within the meaning of IRC § 401(a)(35) and ERISA § 204(j). (For example, for plan years beginning after December 31, 2006, such a plan could not be amended to require that any portion of the plan account of a participant with three or more years of service be required to be invested in company stock.) On the other hand, such a plan was presumably not within Congress's sights when it enacted IRC § 401(a)(35) and ERISA § 204(j), and typically participants in such a plan will

already be well aware of their diversification rights and will have been provided in the past with information regarding the importance of diversifying their retirement savings. Furthermore, while plans that previously did not comply with the new diversification requirements have been on notice since Congress passed HR 4 on August 2, 2006 that they would need to make significant changes in order to comply with the new rules, plans that seemed to require no changes in order to comply may not have paid sufficient attention to the new rules.

On December 8, 2006, the ERISA Industry Committee ("ERIC") sent a letter to Robert Doyle, the Director of the Office of Regulations and Interpretations within the Employee Benefits Security Administration, the agency within the Department of Labor (the "DOL") charged with enforcement of ERISA. Here is a link to ERIC's letter:
http://www.eric.org/forms/uploadFiles/90A300000011.filename.eric_letter_re_diversification_notice.pdf (link live in PDF) The letter explains the predicament facing plans for which the diversification requirements of IRC § 401(a)(35) require no changes, but that nevertheless may fall under the January 1, 2007 notice requirement. Persuasively, in our view, the letter requests relief for such plans and proposes three alternative "fixes:"

- The DOL could announce that the notice requirement simply does not apply to a plan that already met the diversification requirements before PPA 2006's enactment, as long as the plan's participants have been adequately informed in the past of their diversification rights and of the importance of diversifying their retirement savings
- Alternatively, the DOL could delay the deadline for notice in the case of such plans to the date 30 days before the end of the first quarter, allowing plans to include the new § 101(m) notice in other routine communications provided before that date
- Finally, ERIC notes, the DOL could allow notice to be provided by such plans as part of the first benefit statement going out to participants at least 30 days after the beginning of the first plan year to which the notice requirement applies (i.e., the fourth quarter 2006 statement for a calendar year plan)

Because of the lead time required to provide notices by January 1, 2007 if no relief is forthcoming, any relief provided by the Department of Labor with respect to the notice requirement will need to be issued very quickly if it is to be of any use, so stay tuned. Plan administrators that have not already provided the notice should make sure that their preparations are adequate to ensure delivery of the notice by 1/1/2007 if no relief is forthcoming.